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Dow Theory Letters

"The Market as Interpreted under the Dow Theory"

RICHARD RUSSELL
125 East 93rd Street
New York City 28

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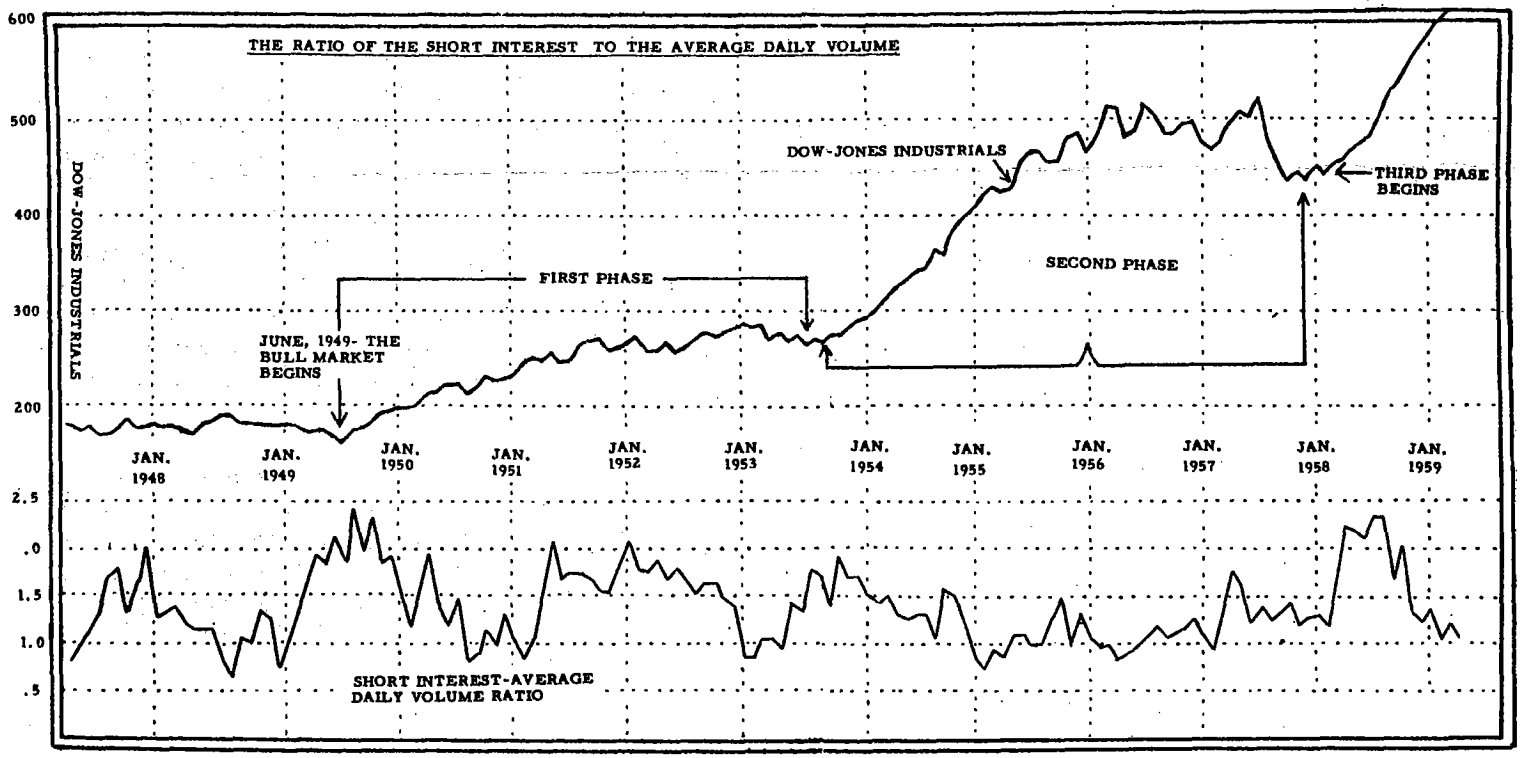
A SPECIAL STUDY OF AN IMPORTANT TECHNICAL INDICATOR



THE SHORT INTEREST-AVERAGE DAILY VOLUME RATIO (S.I. RATIO). One aspect of the market's technical condition which is often discussed in these Letters is the ratio of the average daily volume (over a one month period) to the monthly short interest during that same period. Pictured above is a chart which I have been keeping for many years. It is a seldom-seen study of the relationship of the Dow-Jones industrials to the S.I. RATIO going back to 1947, when BARRON'S first began publishing these figures.

WHAT IS THE S.I. RATIO? Each short seller directly affects the market's technical position, because sooner or later he must cover his shorts. This same principle does not hold true of the stockholder; theoretically, he may hold his long position forever. Often during a bull market, an outside news event (recession, Korea, Suez) will cause a great many people to turn bearish and short the market (in complete disregard of the primary trend). This means that these people have put out their shorts in expectation of a severe collapse. But in order to have a real reaction--one large enough for the shorts to profit in--there must be a heavy volume of selling; it takes selling pressure to drive the market down. When volume remains low, however, and selling pressure is not forthcoming, the shorts are trapped. Low volume during a bull market usually implies that the selling is over. Therefore we can say that the lower the volume and the larger the total outstanding short interest, the stronger the market becomes technically as the ratio of the short interest to the volume is pushed into the bullish upper regions of our chart.

THE CHART. The market is taken to be bullish when the S.I. RATIO registers 1.0 or better, and extremely bullish when it goes over 2.0. The market is considered to be technically weak when the S.I. RATIO drops below 1.0 and bearish when it goes below 0.5. The longer the S.I. RATIO stays in the upper regions of the chart, the greater the ensuing advance.

Note that the S.I. RATIO tends to build up during the early stages of a great advance. In 1949, amidst the severe pessimism, the business recession, and the talk of a post-war depression, the averages held within a shallow range as the S.I. RATIO sky-rocketed to almost 2.5. The primary trend had turned up and the shorts were forced against the wall as the Dow-Jones averages climbed from 161.60 to 293.79.

Again, during the 1953-54 recession, the S.I. RATIO rose to almost 2.0 as the bears (who expected a collapse) put out their shorts during a primary bull trend. The market, after many months of a rising S.I. RATIO, again became sold-out and technically strong. What followed constituted the greatest market rise in history as industrials, starting at 255.49, climbed to 521.05.

During the recent 1957-58 recession, as industrials hit bottom at 419.79 and then began plotting a bullish course, the bears (who refused to believe the story the averages were telling) built up the biggest short position in history. The S.I. RATIO rose to almost 2.5, and the market assumed staggering technical strength. From the chart we can see that the process of running out the shorts is now underway, and this market may well continue irregularly higher until its technical strength is exhausted.

A new factor has been added, however, and this is that we are now in the third phase of a bull market. Once this market loses its internal strength and becomes technically weak due to excessive speculation, lack of shorts, distribution by investors, and inflation of stock values, then the primary trend will finally turn bearish. At this time it is probable that the S.I. RATIO will be probing its lowest level since this bull market began in 1949. This will undoubtedly take the S.I. RATIO well under the 0.7 levels of 1955-57.

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